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# THE NEW ARTICLE NINE OF THE UNIFORM COMMERCIAL CODE: AN INTRODUCTION AND CRITIQUE

William C. Headrick\*

## Part I

### INTRODUCTION

Of all the nine articles which comprise the Uniform Commercial Code, the last one is clearly the most innovative and the most valuable. Even the Review Committee set up to correct its shortcomings began its General Comment by admitting that fact. Its value resides in the enormous progress it accomplishes over preceding statutes and in the wisdom of its policies. It does not reside in the neatness of its technique nor in the clarity of its draftsmanship. Hence the paradox that this most valuable article is the only one requiring a complete overhaul, though it is also true that the overhaul was limited, with very few exceptions, to correcting mistakes and ambiguities of draftsmanship.

What I shall from now on call the old Code or the old Article Nine has five great merits in addition to numerous minor ones: First, it groups all types of security interests together in one comprehensive scheme and provides a single filing system for all of them. Second, it establishes a number of rules common to all of these types, especially with regard to validity and default, thus bringing about simplicity wherever simplicity was possible. Third, it establishes a comprehensive body of rules which attempt to regulate priorities among competing secured creditors. Fourth, it absorbs the sale of accounts receivable and chattel paper, governing them in many respects (validity, perfection, proceeds, priorities) as if they were transactions intended for security. And last, it abolishes with one courageous stroke of the pen a long line of cases, of which *Benedict v. Ratner*<sup>1</sup> was the *reductio ad absurdum*, which required the creditor to police his collateral when it consisted of inventory or accounts receivable, on pain of having his security interest found fraudulent and void. (Section 9-205.)

The old Article Nine has two offsetting demerits which are in themselves sufficient to justify its revision, quite apart from its numerous deficiencies of draftsmanship. These demerits were seriously undermining both real estate financing of fixtures and accounts receivable financing in general. A mortgagee who financed fixtures as a part of the construction of a building could see his rights to these fixtures defeated by a purchase money creditor who filed later. And an accounts financier could be subordinated by later purchase money and chattel mortgage

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<sup>1</sup>*Benedict v. Ratner*, 268 U.S. 353 (1925).

type security interests in inventory, which carried with them a claim to the accounts as proceeds. And, of course, the construction mortgagee and the assignee of accounts can have no real security if subsequent parties can get ahead of them. A revision was needed to safeguard their interests, especially as they are engaged in extremely important types of financing in terms of dollar volume.

Another reason for revision was the widespread introduction of non-conforming amendments, of which, when the Permanent Editorial Board issued its Report No. 3 in 1966, there were no less than 337, with the result that the uniformity of the law was in serious jeopardy. It was then that the Board decided that a "restudy in depth" of Article Nine was required, and it established the Article Nine Review Committee. The members of that Committee were distinguished lawyers, most of whom, however, were not experts in the field of secured transactions. The actual drafting was therefore entrusted to two Reporters, Homer Kripke and Robert Braucher, both of whom were then law school professors. The two Reporters, in turn, were assisted, to an undefined extent, by two Consultants, Grant Gilmore and Peter Coogan, who had gained a reputation as the nation's foremost authorities on the subject of secured transactions by the publication of extensive treatises. After the work of the Reporters was approved by the Review Committee, it was passed on by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and promulgated in May, 1972.

The process of revision appears as a scheme for dividing responsibility from authorship. The critical voting was done by the Review Committee, where the Reporters were disfranchised because they were not members. And the nation's most outstanding experts were removed even from the drafting process, though their views were not, and could not have been, dispensed with. Essentially, this is the scheme that exists in the field of public lawmaking, and which was transferred here to legislation by a private source.

Nevertheless, two differences appear between the work of a body like Congress and the review process of Article Nine. The first is that, whereas the debates and hearings of public lawmakers are published, those which led to the review of Article Nine have remained secret. One is thus deprived of an invaluable source of information for interpretation and critique. Only the most superficial glimpse at what happened can be gained by reading the General Comment on the Approach of the Review Committee, which is appended to the Final Report submitted to the Permanent Editorial Board, a private document dated April 25, 1971. The Reasons for Change, which accompany the new Code, are of course wholly onesided.

The other difference between the revision process and the work of Congress is that while Congress may, within the broad bounds of the

Constitution, legislate what it pleases, the draftsmen of the new Article Nine had to keep in mind the fact that they were an offshoot of the Permanent Editorial Board which had been established in 1961, among other things, to propose amendments to the Code, but only where "[i]t has been shown by experience under the Code that a particular provision is unworkable or for any other reason obviously requires amendment" and also in the case, which did not occur, of a change in commercial practices which would necessitate a change in the law. As they read their mandate, the participants in the revision process felt precluded from taking a fresh look at Article Nine and restructuring it as a whole, and reduced instead to the consideration of amendments to particular sections and subsections which had proved to be unworkable in practice. As even an outward glimpse at their work will reveal, they were faithful to their mandate, which means that most of the changes are either corrections of bad draftsmanship or technical improvements.

The fact that the Revision consists of a series of unrelated amendments rather than a restructuring of the whole, has made this study more discontinuous than the usual law review article. For those who, despite this warning, have decided not to turn pages until they reach the conclusion, I can indicate, as a guiding thread to tell them where they are, that I plan to discuss scope, attachment, perfection, and priorities in roughly that order.<sup>2</sup>

#### SCOPE OF ARTICLE NINE

##### a) LEASES

From its inception, Article Nine encompassed not only secured transactions in the strict sense but also the assignment of accounts and chattel paper, regardless of whether the assignment was an outright sale or a transfer for security. The reason for this extended coverage was not only the difficulty of distinguishing between the two kinds of assignments; it was mainly the thought that the public files should reveal the extent to which the resources of a business were obtained through financing as opposed to capital investment. A functional rather than a formal consideration would thus determine the content of the files. In furtherance of this scheme, the old Code had already taken the step of requiring the filing of consignments in cases where the secured party wanted to avoid the burdensome proof that the consignment was notorious (section 2-326) (3). The Revised Code then complements this rule by adding a section governing the priority of the consignor's interest vis-a-vis that of secured parties (section 9-114 of the new Code).

<sup>2</sup>See Funk, *The Proposed Revision of Article 9 of the Uniform Commercial Code*, 26 BUS. LAW. 1465 (1971); 27 BUS. LAW 321 (1971). This article came to my attention after my own work had been completed.

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required to file, his possession is deceptive to third parties who may wish to acquire a security interest in the equipment, buy it or levy upon it.

If Article Nine included leases of equipment, it would be a self-contained body of law, going beyond secured transactions in the strict sense, and encompassing most situations in which possession is misleading and filing is needed to correct the impression of unfettered ownership it gives. I am not suggesting that the filing system be used every time possession is divorced from complete ownership.

But I do think that the invention of the filing system, as applied to chattels, should be put to full use. It is also good that it was extended beyond security interests, to sales of accounts and chattel paper and to consignments of goods. Beyond that, it should be required for leases of equipment, particularly since such leases constitute forms of financing. And I would add that the difficulty of distinguishing between real leases and agreements characterized by the parties as leases, though their real intent is to create a security interest, is as great as the one of distinguishing between assignments of accounts for security and outright sales of accounts, which is the reason given for inclusion of such sales under Article Nine. The cases are growing in number, in which a judge is asked to determine the true nature of a transaction labeled as a lease, and there is no reason why a loophole should exist in the Code which stimulates this kind of litigation.<sup>5</sup>

#### b) GENERAL INTANGIBLES

Another point relating to the scope of Article Nine, for which the new version does not remedy the ills of the old one, has to do with the relationship between accounts and general intangibles. Sales of accounts come within Article Nine, whereas sales of general intangibles are excluded by section 9-102. (Assignments of general intangibles intended for security are included, however.) The distinction between an account and a general intangible is clear enough, but it is not rational. An account is a right to payment of money for goods sold or leased or for services rendered (section 9-106). "General intangible" is a catch-all expression for intangibles which are neither merged into a piece of paper (like instruments, documents of title, chattel paper, and money) nor constitute accounts. Hence any right to the payment of money, which does not stem from a sale, a lease, or the performance of services, is a general intangible. Among such rights is the right of a buyer to a refund for returned merchandise, the right of a lender to the payment of his loan (provided it was not embodied in an instrument), the right to royalty payments for the use of patents and trademarks, the right to insurance payments, to damages for breach of contract, etc. The Com-

<sup>5</sup>See Leary, *Leasing and Other Techniques of Financing Equipment under the U.C.C.*, 42 TEMP. L. Q. 217 (1969); Stanley v. Fabricators, Inc., 459 P.2d 467 (Alaska 1969).

ment to section 9-106 also suggests that the compensation for the right to exhibit motion picture and television films is a general intangible, which assumes that the exhibition contract is not a lease of goods, but some innominate sort of agreement. In addition to this class of intangibles, which are rights to the payment of money, there is another class, which simply constitutes intangible personal property, such as the patent or trademark itself.

The expression "general intangible," then, includes two very different types of assets: the first type, which is made up of miscellaneous rights to the payment of money, has close affinity to accounts, and is at times assigned under the same contract; the second type is composed of patents, copyrights, and other similar rights.

It makes sense to include within the scope of Article Nine, security interests in this second type of property, while at the same time excluding from it the sale of such items, since their sale is not a means of financing, whereas their pledge most assuredly is. But the same thing cannot be said of the first type of general intangible, which represents a right to the payment of money. That type is discounted, sometimes along with accounts in a single contract. Hence it would have been much more rational to divide intangible property into two categories: accounts, which are rights to the payment of money from whatever source, and general intangibles, which are all other kinds of intangible property.

The Review Committee considered this suggestion, but turned it down. It expressed its views as follows:

A more limited suggestion is to rectify the definitions of "accounts" and "general intangibles". It has been pointed out that some obligations for payment of money are not accounts, but are general intangibles, because the definition of "account" is limited to rights to payment for goods sold or leased or for services rendered. Thus, rights to payments constituting royalties for use of patents, copyrights, etc., or for exhibition rights to moving pictures and television, seemingly constitute general intangibles rather than accounts. A potential source of error by inadvertence thus arises. The Committee nevertheless concluded that it would be undesirable to broaden the definition of accounts to include all rights for the payment of money, because too many standard forms of agreement use the term "accounts" and reflect intention of the parties to include only traditional accounts arising from the sale of goods or services, and not miscellaneous rights for the payment of money.<sup>6</sup>

I find this reason wholly unconvincing. The fact that present-day forms which are filled out to evidence assignments of accounts use the word "account" in the sense given it by the old Code is no reason for refusing to change the legal definition of that word. Those financiers who might wish to buy or discount all rights to the payment of money could continue to use the word "account" in their agreements and those who did not care to acquire such rights could amend their forms

<sup>6</sup>Review Committee for Article 9, *Final Report*, General Comment on the Approach of the Review Committee for Article 9, § E-15.

accordingly. But even if they failed to do so, no great harm would ensue, inasmuch as they would not receive these rights unless they paid for them, and the calculation of the discount price would reveal the parties' true intent.

### c) CONTRACT RIGHTS

One difficulty with basic concepts which was happily cured by the Revision, has to do with the relation between an account and what the old Article Nine calls a contract right. A contract right is defined in the old section 9-106 as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper." The difference between an account and a contract right, then, is that an account has been earned by performance, whereas a contract right has not. A common example of a contract right is the right of a builder to progress payments which will not become due until the construction reaches certain stages, but which are nevertheless often assigned by the builder in order to finance the construction. Under the scheme of the old Article Nine, when the right to payment arises under a contract right, the account into which it transforms itself is proceeds of the contract right (section 9-306(1)).

The existence of the special concept of contract rights in the old Article Nine was justified on the ground, stated in the Comment to section 9-106, that "there is reason to allow the original parties—assignor and account debtor—more flexibility in modifying the underlying contract before performance than after performance." This policy was carried out in section 9-318, where it is laid down that the parties to the original contract may, despite assignment, make any modification or substitution "in good faith and in accordance with reasonable commercial standards."

The new Article Nine has discarded the contract right as a separate concept, while still preserving the policy of old section 9-318. Wherever the expression "account and contract right" appeared in the Code, it was replaced by the short word "account," and section 9-318 was changed to read that whenever the right to payment of an account "has not been fully earned by performance," the parties may make their good faith and commercially reasonable substitutions. Thus was accomplished, not a change in substance, but an economy of concepts and words.

### *Relationship between attachment and perfection*

In the way it governs the relationship between attachment and perfection, Article Nine stands half-way between two theoretically clear solutions: the first, which is the one used for real estate mortgages, consists in making the agreement of the parties binding between them without need of recordation, and in using the filing or (as it is called in the real property area) the recording system as a means of giving constructive notice to later purchasers. Under this system, if a purchaser



has actual knowledge, he cannot complain about the lack of recordation, because the recordation is only intended to give him the information which he already has.<sup>7</sup>

The opposite system would require recordation for the validity, even as between the parties, of the security agreement. It would be a formality which would have to be accomplished and its effect would be to blur any distinction between attachment and perfection.

Article Nine stands half-way between these extremes. As between the parties, the security agreement attaches without any need for perfection; but filing is much more than a means of giving constructive notice. It is also a way for the creditor to prove that he is serious about obtaining his security interest, and hence lack of filing often prejudices him (in the area of priorities, and under the new Code, even against lien creditors) despite knowledge of his security interest on the part of the third parties with whom he is competing.

In my opinion Article Nine should have gone the whole way in its movement away from the constructive notice system and reached the goal of perfection as a formal requisite for validity.

Essentially, the question is how much formality is desirable in a security agreement. Formal requisities exist mainly as proof of seriousness, although when the formality is a writing evidentiary purposes are served as well. Under case law prior to the U.C.C., judges had devised two principal rules designed to ensure the seriousness of a security agreement: the first was the requirement that the description of the collateral in the chattel mortgage be precise and meticulous; the other was the need, which courts imposed on secured parties, to police their collateral. Both of these rules have been, wisely I think, abolished (sections 9-110 and 9-205). But nothing has been put in the Code to replace them as safeguards against the casual execution of security agreements. The existence of a Statute of Frauds is not enough. It allows security agreements to be inserted as boiler-plate clauses in promissory notes, and the borrower's signature at the bottom of that form, without any further formality on the part of anyone, is sufficient to give the secured creditor very special rights of execution.

There is a simple means of ensuring that when the creditor obtains the agreement, he really means to have it. That is to require him to file a financing statement or perfect his interest in some other way. Under such a system, filing would be a condition not only of perfection, but also of enforceability against the debtor. The system, if it were adopted, would therefore do away with the dichotomy between these two concepts, and bring about some simplification in the overall structure of the Code.

<sup>7</sup>The doctrine that actual knowledge prevents reliance on the lack of recordation is the majority rule. It has been severely criticized. G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES, § 206 (2d ed. 1970).

### *Validity of the security agreement*

"Attachment" and "enforceability" are the twin concepts used by the old Code to describe the validity of the security agreement against the debtor. Attachment is achieved when "there is agreement that it [the security interest] attach and value is given and the debtor has rights in the collateral," section 9-204 (1). Enforceability is only attained when, in addition to compliance with the requirements for attachment, the secured party has been put in possession of the collateral or "the debtor has signed a security agreement which contains a description of the collateral and, in addition, when the security interest covers crops or oil, gas or mineral to be extracted or timber to be cut, a description of the land concerned," section 9-203 (1) (b).

The new Article Nine groups all the requirements for validity under one heading and says in new section 9-203, that "a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless . . ." there is possession or a signed security agreement, value has been given, and the debtor has rights in the collateral.

The Statute of Frauds requirement for this enforceability is that the debtor have signed a security agreement which contains a description of the collateral and in some cases also of the land, notably, under the new Code, in the case of crops or timber, and under the old Code, also in the case of oil, gas, or minerals.

The reason for the deletion of minerals from the requirement of a description of the land is that they are not included within the coverage of the Code until after they have been extracted. This is apparent under the old Code from the fact that they are neither goods nor fixtures, and also from section 9-204 (2) (b), which states that a debtor has no rights in "oil, gas or minerals until they are extracted." It made no sense to the draftsmen of the Revision to require the land to be described when the only kind of minerals in which a Code security interest can attach are those that have lost their character as realty.

Nevertheless, if the minerals to be financed are those which will be extracted from a particular mine or well, an indication of the location of that well or mine is necessary as a means of identifying the collateral. The rules on filing of the corresponding financing statement lend support to this requirement. See section 9-401.

The question which has come up in several cases and received a non-uniform answer, whether the Article Nine Statute of Frauds is satisfied if the debtor signs such a financing statement, has been left by the Revision in its present state of doubt.<sup>8</sup>

<sup>8</sup>See G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, 347-348 (1969), (requirement satisfied); *contra*: Mid-eastern Electronics, Inc. v. First Nat'l Bank of S. Md., 380 F.2d 355 (4th Cir. 1967); M. Ruffin Electric Supply Co., Inc. v. Burdette

The better view in my opinion is that the signing of any writing, whether labeled security agreement or financing statement, should be sufficient for purposes of enforceability. After all, in substance there is no difference between a security agreement and a financing statement. A financing statement is nothing but a short-form security agreement which was invented to save space in the files. Hence the new section 9-203 should have provided that a security interest is enforceable if, *inter alia*, the debtor has signed a "writing" (instead of a "security agreement") which evidences his intent to secure a debt and contains a description of the collateral and, in some cases, also a description of the land.

Under both the old and the new Article Nine, a security interest, once having attached, may continue in proceeds and after-acquired property. In view of the fact that these extensions of the security interest are enforceable against the debtor without regard to perfection, I shall treat them now, while bearing in mind that in the usual case such interests are in fact perfected, and the claim of the secured creditor is disputed by a third party, not by the debtor.

### *Attachment of Proceeds*

#### a) INSURANCE PROCEEDS

Proceeds are defined as "whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of." Section 9-306(1). The two words missing in this enumeration are "damaged or destroyed," and from that omission it could be inferred that insurance proceeds are not "proceeds." To resolve this problem the new Article Nine provides that "insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement." Section 9-306(1). These words are addressed to the situation where the debtor or the secured party has procured the insurance. They leave in doubt the question, which is especially important in the case of automobiles which are damaged or destroyed by a third person, whether the cause of action against the tortfeasor or his insurer can be claimed by the secured party as proceeds. If the tortfeasor is insured, the question is whether the insurance is "payable" to the debtor under the new phrasing; if he is uninsured, it becomes a matter of extending the concept of proceeds beyond the area of insurance by means of an analogy which I think is called for, though not at all spelled out. It would have been better simply to add the words "damaged or destroyed" to the enumeration of what constitutes proceeds, instead of framing

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Electric, Inc., 98 N.J. Super. 378, 237 A.2d 500 (1967); American Card Co., Inc. v. H.M.H. Co., 97 R.I. 59, 196 A.2d 150 (1963). See also *In re Center Auto Parts*, 6 U.C.C. Rep. Serv. 398 (D.D. Cal. 1968) and *Safe Deposit Bank and Trust Co. v. Ber-*  
*man*, 393 F.2d 401 (1st Cir. 1968).

a special rule for cases of insurance only. This defect in the new Code can, however, be remedied by inserting in the security agreement a clause whereby the debtor assigns his causes of action for damage or destruction of the collateral, to the secured party.

#### b) THE NEED TO CLAIM PROCEEDS

Next arises the question: is it necessary to claim proceeds in the security agreement or does a right to proceeds arise by operation of law, subject to an agreement of the parties to the contrary? Section 9-306 (2) of the old Article Nine states plainly that "a security interest . . . continues in any identifiable proceeds including collections received by the debtor." Standing by itself, the section leaves no room for argument, and yet in section 9-203 there appears the phrase that "in describing collateral, the word 'proceeds' is sufficient without further description to cover proceeds of any character." Apart from being superfluous, this phrase throws into doubt the rule of section 9-306 (2). What need is there to tell the prospective parties to a security agreement that the magic word is "proceeds" when there is no need to claim proceeds in the first place? Still further darkness is shed on this question by the form of a financing statement, which the draftsmen had the kindness to supply practising lawyers in section 9-402 (3) and on which appear the lines: "(If proceeds or products of collateral are claimed) Proceeds—Products of the collateral are also covered."

Again, what need is there to claim proceeds in the financing statement if the right to them arises by operation of law? Fortunately, this question did not arise very often, because secured creditors immediately formed the habit of checking the little box on the financing statement in order to claim proceeds.

The new Article Nine has eliminated the inconsistency of the old one on the question of claiming proceeds, and has laid down the simple rule that "unless otherwise agreed a security agreement gives the secured party the rights to proceeds provided by section 9-306." The decision to make a claim to proceeds implicit in a security agreement was based on the existing practice of invariably claiming them. The new rule thus not only accords with the probable intent of contracting parties, but reduces the complexity of security agreements and the problems which arise under the old Code from an inadvertent failure to check the little proceeds box on the financing statement.

#### c) NEED TO CLAIM "PRODUCTS"?

One mystery remains to be solved about the financing statement under the new Code. It stems from the fact that, although the word "proceeds" has been eliminated, the word "products" remains. This word is nowhere defined and the only place it is used is in the form of the financing statement. Under the old Code, it might be explained away as a synonym of proceeds, since anyone who checked the proceeds box

would be getting "proceeds or products." But under the revision, where "products" stand alone to be checked off, they appear to mean something else. If they are, in a literal sense, those things which are produced by the collateral, then we are in for some big surprises. The crops produced by a tractor, the woollens produced by a knitting machine, the sheet metal produced by a steel press, in short, the inventory manufactured with equipment could simply be claimed by the equipment financier by checking off the "products" box, without further particulars. But inasmuch as this reading is totally absurd, the best that can be hoped for is that the word "products" has no meaning and hence that the "products" box on financing statements should be eliminated.

#### d) CASH PROCEEDS OUTSIDE INSOLVENCY PROCEEDINGS

A further question relating to proceeds is the extent of the property they cover. A difficulty arises with respect to cash proceeds which have been deposited in a bank account and there commingled with the debtor's other funds. To be claimed, proceeds must be identifiable (section 9-306 (2)), and the question arises whether proceeds which have been commingled are nonetheless identifiable. Neither the old nor the new Article Nine provide an answer to this question, except in the case in which an insolvency proceeding (such as a bankruptcy proceeding, equity receivership or statutory assignment for the benefit of creditors) has been instituted against the debtor. In substance, the rule for these proceedings, given in section 9-306 (4), is that the secured creditor may claim as proceeds only the amount which was deposited in the debtor's bank account during the ten days prior to the institution of the proceeding.

But suppose that a general creditor levies on the debtor's bank account without instituting an insolvency proceeding, and that the secured creditor intervenes to assert that a part of that bank account is proceeds of collateral by which he was secured. We are faced with two possible solutions. The first would simply consist in saying that proceeds which have been commingled are not identifiable, thus ruling against the secured creditor. The second would be to say that if the secured creditor gets some commingled cash proceeds in bankruptcy, he ought to get at least as much outside of bankruptcy. However, subsection (4) of section 9-306 is intended as an exception for insolvency proceedings only, and hence cannot be applied by analogy to the non-insolvency, everyday judicial proceeding. That leaves open only one possibility, which is to let the secured creditor have as proceeds all the cash that is traceable to his collateral and was deposited, minus the amounts thereof which the debtor may have already disposed of. For the determination of the net amount of cash, a formula such as "first in, first out" might be employed.

have minutely regulated cash proceeds in the case of insolvency proceedings, yet left them wholly untouched outside of that area. The number of inconsistent cases on the tracing of proceeds is large enough to make the problem inescapable.

### *Attachment of after-acquired property*

There is good reason for allowing after-acquired property clauses to be inserted in security agreements. Their function is to make possible the floating security on inventory and accounts. A creditor secured by present and after-acquired inventory loses some of his security every time an item is sold to a buyer in the ordinary course of business; to make up for that loss, he gains a security in inventory newly acquired to replace the item that was sold. Thus, he has a right which covers the inventory at whatever level it may stand at a particular time. The same can be said of the assignee of accounts, whose mass decreases whenever an account is collected under a non-notification method whereby the debtor makes his own collections and may keep the proceeds. It increases whenever a new account arises from a sale of merchandise. Since under these sorts of arrangements the value of the security fluctuates, the security agreement most often calls for fresh advances or repayments to be made so that the amount of the indebtedness remains in a constant ratio to the collateral.

#### a) FUTURE CROPS

There are also cases where the after-acquired property clause serves no useful purpose and is in fact detrimental to the public interest. Under the old Article Nine, there are two cases in which an after-acquired property clause is void: when it covers crops which are more than one year in the future, unless given in connection with a lease or land purchase or improvement loan, and when consumer goods are being financed (section 9-204(4)(a) and (b)).

The rule on future crops was of course intended to protect the farmer from greedy lenders by preventing him from mortgaging his crops for the future and putting himself in a position where he cannot obtain financing for later current crops. But the old Article Nine also makes it possible to evade this wise and sensible provision, not only in land purchase and improvement contracts, for which an exception is specifically made, but also in all other cases. The way around the rule is to make the farmer come in every year to get an extension on his note, at which time he must execute a new security agreement on his current crop. Priority for the new loan is already assured by the notice filing made at the time of the original loan. In the end, the rule creates paperwork without helping the farmer.

I suppose that if farmers had been as well represented as banks in the revision process, the prohibition on mortgages of future crops would have been strengthened, on account of the vital importance for

farmers to be able to obtain financing for the planting and harvesting of a current crop, despite bad previous years which might have put them in default to their former lenders. But for a bank, the important thing is to be secured with as many of the debtor's assets as possible. In the end, therefore, the prohibition on future crop mortgages was completely wiped out.

#### b) FUTURE EQUIPMENT

Under the new Code there is only one area in which after-acquired property clauses are void, and that is the area of consumer goods. But what about goods which are neither inventory (for which the clause serves a good purpose), nor consumer goods? In particular, what about agricultural and industrial equipment? Is there any reason for allowing after-acquired property clauses covering such equipment? In most cases, equipment is financed on a purchase money basis and the financier relies only on the item sold in extending credit. Yet he usually has, as a precaution or out of habit, inserted an after-acquired property clause in his security agreement. He thus takes priority as to equipment on which he never relied, against other creditors who furnished the means of purchasing it, provided they are for some reason, such as an inadvertent failure to file, unsecured. He also obtains privileged rights of execution against the debtor as to property which he never furnished.

Some recognition is given to this factor by section 9-108. It states that after-acquired property is deemed to secure an antecedent debt, and hence is voidable in bankruptcy if acquired during the four months preceding the date of filing of the petition and at a time when the secured creditor knew his debtor was insolvent<sup>9</sup> unless it is either acquired in the ordinary course of business or pursuant to the security agreement and within a reasonable time after the advance was made. Thus only two kinds of after-acquired property are bankruptcy-proof even during the four-months period: after-acquired inventory, because it is acquired in the ordinary course of business, and after-acquired equipment which was specifically contemplated in the security agreement and quickly obtained.

It seems to me that the same reasons that militate against the validity of the "just in case" variety of after-acquired property clause in bankruptcy also work against it outside of that particular proceeding. The only justification for the privilege implicit in a security interest is the incentive it gives the financier to extend credit. Thus there is no reason to provide him, by means of a boiler-plate clause in his security agreement, with a right on which he does not rely, and in fact cannot rely, because the equipment contemplated by the clause may never be acquired. In short, I find cause for regret in the fact that the revision does not void after-acquired property clauses covering unanticipated equipment, just as it voids them in cases of consumer goods.

<sup>9</sup>Bankruptcy Act, § 60, 11 U.S.C. § 96 (1964).

*Attachment and perfection for crops, timber, minerals, and fixtures*

Article Nine is primarily intended as a security law for chattels, yet it touches upon some types of property which are on the borderline between realty and personalty.

a) CROPS

Growing crops are attached to the soil, yet under both Article Two and Article Nine of the Code, they are treated as if they were goods. A present sale of crops can be made before severance (section 2-107 (2)) and a security interest in them can be created in that state, since "goods" are defined to include growing crops (section 9-105 (f) of the old Code and 9-105 (h) of the new one). Then a problem arises—how to resolve the conflict between these chattel interests in the growing crops and the real estate rights of mortgagees and grantees?

In the case of a sale of growing crops, the rule laid down in section 2-106 (3) is that a grantee or mortgagee who has recorded his right prior to the sale prevails over the buyer of the crops, and that if the buyer wishes to prevail against future mortgagees and grantees, he has to record his purchase in the realty records.

The rule for security interests is different. The place to file a crop mortgage, under both the old and the new Article Nine is in the chattel files which, depending upon the "alternative" chosen by the state, is either the office of the Secretary of State (alternative one) or the county office where the debtor has his residence and also where the land is situated (alternatives two and three). Section 9-401.

The arguments made in the General Comment for not harmonizing the crop mortgage rule with the crop sale rule are that to do so would make it more cumbersome to mortgage crops, since a "legal description" of the land would have to appear in the mortgage and that it would, in most states, disturb the existing practice of filing crop mortgages in the chattel records. These reasons are not convincing, because the question whether a "legal description" is needed could have been made optional for each state in the case of crop mortgages, just as it is in the case of timber, minerals, and fixtures in section 9-402 (5). The disturbance of existing practice is not too high a price to pay for a consistent and viable system.

Indeed, the rule on crop mortgages is doubly inconsistent: not only does it not coincide with the rule on crop sales, but it also differs from the rule on timber and fixtures. What's more, filing crop mortgages in one place and other realty interests in another doubles the effort needed for a realty search on agricultural land, and leaves up in the air the problem of priority between crop lenders and other realty interests. The Review Committee was fully aware of this gap, since



in paragraph B-5 of its General Comment it declared: "The Committee has not thought it possible in the Uniform Code to deal with the diversity of existing state law on the interrelation of chattel security interests in growing crops and real estate interests." Among the problems left unsolved are the following: Is a real estate mortgage in which crops are claimed, perfected as to the crops if it is filed only in the realty records? If so, does it have priority over a later crop mortgage filed in the chattel records? Does a grantee of the land, who has actual knowledge of an unfiled crop mortgage, prevail over the crop mortgagee? And does a crop lender, who has actual knowledge of an unrecorded sale or encumbrance of the real estate, prevail over the real estate party? Would a crop mortgage be perfected if it were mistakenly filed in the realty records? I think that enough problems have been posed to show that there is only one sensible way to resolve priorities between crop mortgages and realty rights in crops, and that is to have a single filing place for all such rights, which, of course, would have to be the real estate records.

b) **TIMBER**

The system established by the new Code for uncut timber is, I think, the right one, and it should have been applied to growing crops as well. Uncut timber under the new Code is no longer realty for purposes of sales law, and the change which was thus brought about is the only important departure by the Review Committee from its concern with Article Nine (section 2-107). Timber is also "goods" for purposes of Article Nine (section 9-105), and thus both a sale and a mortgage of uncut timber can be effectuated under the simpler formalities of the law of chattels. Nevertheless, for perfection, timber deeds and timber mortgages must be filed in the realty records (section 2-107, 9-401 (1) and 9-403 (7)). It may seem inconsistent to describe timber as personalty and provide for the filing of interests in it in the realty records, yet this solution contains in it the best of both worlds—it facilitates timber transactions by subjecting them to the rules devised for chattels, and yet it affords protection to competing real estate interests through the requirement of a realty filing.

The third parties against whom a timber filing gives protection are not only persons with interests in the real estate, but all other persons who assert adverse rights in the timber alone. With respect to timber mortgages, this conclusion can be derived from the fact that the filing in the realty records has the same effect as a filing in the chattel records. With respect to timber sales, the rule emerges from the words of section 2-107 (3) which grant effectiveness to such sales "subject to any third party rights provided by the law relating to realty records." Although the point is not free from doubt, I believe that those rights are not only the rights of real estate parties, but also rights of others which are perfected by filing in the realty records, in-

cluding timber mortgagees, and the rights of lien creditors, to the extent that under state law they would prevail over buyers of the land who had not recorded their deeds.<sup>10</sup>

### c) MINERALS

Unharvested crops and uncut timber are "goods," but unextracted minerals are real property. No Article Nine security interest can attach in them until they leave the ground. The new definition of "goods" in section 9-105 clearly makes this point by saying that goods "does not include . . . minerals (including oil and gas) or the like before extraction." The old Article Nine makes the same point differently, by providing in section 9-204 (2) that "the debtor has no rights . . . in oil, gas or minerals until they are extracted. . . ." But a security interest often attaches to minerals the minute they are extracted, and hence two questions arise. Must the land from which they are obtained be described in the security agreement and financing statement? And must the filing take place in the realty records or the chattel records?

In answer to the first question the inference from the new section 9-203 (1) (a) is that a description of the land is not required. Here the draftsmen went too far in changing the old Code. The old Code provides that the security agreement must describe the land in the case of "oil, gas or minerals to be extracted." The last part of the statement is misleading since it assumes that a security interest in unextracted minerals can arise under the Code. But instead of simply deleting that phrase, the Review Committee should have replaced it with one which requires the land to be described when the security interest attaches to minerals as they are extracted, as a means of identifying the collateral.

This defect is, however, cured by the requirement that the land be described in the financing statement. The reason for the requirement is the rule that security interests in extracted minerals must be filed in the realty records (new section 9-402 (5)). Here we encounter the same paradox as in the case of uncut timber, a security interest in property characterized as goods must be filed in the realty records. A difference does, nevertheless, exist. Uncut timber is still very firmly connected to the soil, and hence its characterization as goods is a fiction indulged in to facilitate transactions relating thereto; but minerals which have already been extracted are truly goods. The reasons for the real estate filing has to do with the practice of selling the minerals at the wellhead or minehead. The owner of the production who is not the mining or petroleum company itself, but merely an investor, sells his minerals as they are extracted to the company. The lender who financed his acquisition of the production rights, finds himself secured by the

<sup>10</sup>On the protection afforded by real property recording acts to creditors, see OSBORNE, *supra* note 7 at § 210.

account receivable as soon as this sale has taken place. Hence it is really the account that the draftsmen had in mind; but since the production rights are typically divided into fractional rights and their owners are spread around the country, it would have made no sense to follow the usual rule for accounts, which is to file at the assignor's residence. That left the place where the well or mine is located as the only feasible place to file, and the decision to choose the realty records in place of the chattel records was made simply on the basis of existing practice.

#### d) FIXTURES

Everyone knows the meaning of such words as "crops," "timber," and "minerals." But what is a fixture? The old Article Nine proclaims in section 9-313 (1) that a fixture is whatever "the law of this state other than this Act" determines to be such. The new Article Nine has discarded this simple approach, and sets about, not to define the word "fixture," but to say which kinds of fixtures it is concerned with. Thus building materials which are incorporated into the land may be fixtures for some purposes, but section 9-313 (2) specifies that no security interest can be created in them.

At the opposite extreme, objects described as "readily removable factory or office machines or readily removable replacements of domestic appliances" can be fixtures under local law (section 9-313 (4) (c)), although no fixture filing is needed for priority in them, even over real estate parties.

In addition to these two extreme types of fixtures, there is of course the broad in-between area, in which the decision whether a thing is a fixture will depend on how it is characterized by the law of each state. This reference to the general law of the state is found in section 9-313 (1) (a) of the new Code which says: "Goods are 'fixtures' when they become so related to particular real estate that an interest in them arises under real estate law." Whether, for example, a prefabricated steel shed, a window air conditioner or a mobile home is a fixture, is a question the answer to which may not be uniform. Nor is there a need for uniformity, because the conflict between Article Nine security interests and real estate interests can only arise if the disputed object is a fixture by state law.

In other words, the fact that a thing is a fixture under the Code's use of the word doesn't mean that a security interest can attach in it (there can be no security interest in building materials); nor does the fact that a thing is a fixture mean that a fixture filing in the realty records is required (no such a filing is required for readily removable machines, etc.) Thus the word "fixture" becomes very confusing. One has to ask what kind of a fixture is involved before one can find the applicable rule. And there are three kinds of fixtures: building materials incorporated into the land, which are outside the scope of

Article Nine; certain readily removable machines and consumer goods, which are within the scope of the Article, but as to which no fixture filing is called for; and a number of other fixtures, for the determination of which one must look to state law.

One of the gravest defects of the old Article Nine and one of the principal reasons why it needed to be revised, is that it makes no provision for a fixture filing, that is, a filing of a security interest in fixtures in the realty records. The old rule is that a filing of security interests in fixtures must take place in the office where a mortgage on the land would be recorded (section 9-401), and most officers in charge of recording mortgages understandably read that expression as meaning that they had to keep a new book in their office for the filing of security interests in fixtures. A search of the real estate records therefore does not, under the old system, reveal the existence of encumbered fixtures. A double search has to take place for complete information on the state of the property.

The new Article Nine does away with this duplicity and establishes the principle that a fixture filing must be in the realty records, so that a search of the title will reveal what fixtures, if any, located on the land are subject to security interests.

The fixture filing requirement applies to all fixtures covered by the Code (i.e., all fixtures except building materials) with the exception of "readily removable factory or office machines or readily removable replacements of domestic appliances which are consumer goods." Section 9-313 (4) (c).

A new group of problems is thus created in the area which I shall describe in a manner consistent with the Code, though admittedly self-contradictory, as "readily removable fixtures." It is clear that the question of what is readily removable is one which must be decided by applying the words of the Code, not pre-Code cases on real estate matters. It is a question to which a uniform answer must be given. Thus, for example, if a state decision holds that a machine bolted to the floor is a fixture, it cannot be followed to decide whether or not it is "readily removable" under Article Nine. The decision will have to be that it is readily removable. The Review Committee preserved the label "fixture" for these things precisely in order to allow the old cases to continue to govern in other areas, while substituting a new test under Article Nine.

Two types of things are susceptible of being "readily removable fixtures": factory or office machines and replacements of domestic appliances which are consumer goods. To begin with the factory or office machines: Why did the draftsmen choose the word "machines" instead of falling back on the familiar notion of equipment? The undefined word "machine" is not at all so clear as might seem at first sight, besides which there is no reason for distinguishing between removable

machines and other removable equipment, such as, for example, a workbench or a vise (assuming that a vise is not a machine) or a window air conditioner (assuming that it isn't an office machine).

Turning now to consumer goods: for a security interest in them to be exempt from a fixture filing, they must be removable, replacement appliances. Thus no less than three conditions must be met: the consumer goods must be appliances; they must be replacements; and they must be removable. The rules on consumer goods appear stricter than the ones on equipment, for which there are only two requirements, namely that they be machines and removable ones.

Why are only appliances exempt from fixture filing, assuming they comply with the other two requirements? I assume the word "appliance" is synonymous for "machine," i.e. that an appliance is a household machine. Therein may lie the explanation of why only appliances are exempted. But, that does not mean that the distinction between appliances and other consumer fixtures is the right one. The effect of the rule is that security interests in curtains, ceiling lamps, built-in hi-fi equipment or rugs nailed to the floor, if they are fixtures by real estate law, are subjected to fixture filings, whereas stoves, refrigerators, water heaters, etc., even if they are fixtures by real estate law, are exempt from fixture filings as long as the other requirements of being replacements and removables are met.

Next, why need the consumer appliances be replacements? Why are not original consumer appliances exempt from fixture filings as well? To these questions the last paragraph of Comment 4 (d) to section 9-313 provides the answer. The draftsmen had in mind the priority contest between a construction mortgagee and a later purchase money financier of consumer goods. Their aim was to make the construction mortgagee safe from the danger that the building contractor, after the house had been mortgaged together with all its fixture appliances, would buy and install original fixtures subject to higher-ranking purchase money interests. The means of achieving this end was to require a fixture filing for original appliances before the filing of the construction mortgage. Under the rule, therefore, any mortgagee contemplating financing a home construction can know from a search of the realty records exactly which interests may be superior to his and can rest assured that no later interest will come ahead of him.

I shall have more to say about construction mortgages when I reach the subject of priorities. At this point, it is sufficient to point out that the requirement of a fixture filing for original appliances exists only for the sake of protecting the construction mortgagee. Therefore, despite broader wording, it appears to me that no fixture filing of original appliances is needed in a conflict with real estate parties other than construction mortgagees. Such parties, who can be later grantees or later mortgagees or even prior non-construction mortgagees, take sub-

ject to a conflicting security interest in any removable domestic appliances, be they original or not. To state the matter differently, a fixture filing is, generally speaking, required only for non-removable domestic appliances, as well as all other consumer fixtures; however, for purposes of priority over construction mortgagees, a fixture filing is also required for those removable appliances which are original and are considered fixtures by property law.

All would be well, were it not for the fact that the field of consumer appliances is not covered by the two words "replacements" and "originals." There are certain consumer appliances which are not installed in a house when it is built and yet do not replace other, worn out appliances either. Such objects might be called additional appliances. Is a fixture filing required for them in a case of conflict with a construction mortgagee? There is much more similarity between additions and replacements than between additions and originals, since a construction mortgagee relies only on originals, and cannot foresee the existence of either replacements or additions. Hence, in my judgment, no fixture filing is necessary for additional removable appliances.

After having thus stated the rule, it is necessary to state why it exists. Why is there the requirement of a fixture filing for removable original appliances and not for removable original factory or office machines? The answer lies in the fact that construction mortgages often cover the construction of a home and its appliances to the extent that they are fixtures; whereas separate financing is usually obtained for office and factory machines or, if the same lender is involved, a separate security agreement is customarily entered into.

To recapitulate: there is no such thing as a fixture for purposes of Article Nine. The word "fixture" is used in the sense which local law may give to it. The correct question is: when is a fixture filing required? It is not required for all fixtures. For purposes of priority against real estate parties in general, it is required for all fixtures except removable machines and removable appliances. But for purposes of priority against construction mortgages, it is also required of removable original appliance-fixtures.

And to take a long view of everything said so far concerning property which lies at the boundary between chattels and realty: a filing in the real estate records (called a fixture filing in the case of fixtures and otherwise without a special name) is required for security interests in standing timber, extracted minerals and all fixtures encompassed by Article Nine with the exception of "readily removable fixtures" other than original domestic appliances when the real estate party is a construction mortgagee. On the other hand, security interests in crops are, mistakenly I think, excluded from the requirement of a realty filing, and no rules whatsoever are given to resolve the problems of priority between crop mortgagees and real estate parties.

## e) ERRONEOUS FILING

Two more questions remain: First, what is the effect of making a chattel filing when a realty filing is required? Such a mistake in filing on the part of a creditor is understandable, inasmuch as he does not always know to what use the debtor will put the thing sold.

For fixtures, the answer is provided in section 9-313 (4) (d): even a chattel filing is good enough to defeat a lien creditor. This principle constitutes a valuable departure from the old Code, under which the proper place to file a security interest in fixtures is in the office where real estate mortgages are filed (section 9-401), from which it follows that no filing elsewhere is of any use at all, not even against lien creditors. The reason given for this change in Comment 4 (c) to section 9-313 is that "generally a judgment creditor is not a reliance creditor who would have searched the records."

But on this point, the rule for timber and extracted minerals is different from the rule on fixtures. A chattel filing of such interests is totally devoid of effect. The reason for the special rule on fixtures, which is to prevent total loss to the secured party who guessed wrongly about the affixation of the thing, does not apply to timber or extracted minerals. Their nature is not subject to unforeseen changes.

Second, what is the effect of a fixture filing made by the secured party with the expectation that the goods would become fixtures, when in fact the debtor fails to install them? Would the secured party be protected against judicial liens? He would be if the security interest could, in the words of section 9-313 (4) (d), be considered "perfected by any method permitted by this Article." But is recording in the realty records a method of perfection permitted by "this Article" for security interests in chattels?

I hesitate to give a negative answer to this question, especially for the case in which the debtor has indicated that he would use the goods as fixtures, or in which the goods are normally used only as fixtures. A negative answer means that a person selling goods destined to become fixtures, if he wants to be fully secure from the time of delivery onward, has to either spy on the debtor to be sure that the goods have been installed or else file doubly, first in the chattel records and then in the realty records. There is no indication that the Code imposes such a burden of double filing. What is more, in the converse situation in which the creditor has filed in the chattel records in spite of the fact that the goods have become fixtures, the new Code generously allows perfection against lien creditors (section 9-313 (4) (d)), and the Comment even goes so far as to hope that this chattel perfection of realty will stand up in bankruptcy under the lien creditor test applicable to personal property (Comment (c) to section 9-313). Bearing in mind this policy of leniency toward the purchase money creditor, the better view, and the view which, I think, should have been made explicit, is

that a fixture filing of goods destined to become fixtures is effective against lien creditors even though the chattel is, contrary to expectation, belatedly or never installed on the land.

#### f) TRANSMISSION UTILITIES

A broad exception to the requirement of a fixture filing in the realty records of the place where the fixture is situated, is given for so-called transmitting utilities, which are defined casuistically in section 9-105 (n) as railroads, suppliers of electricity or oil or gas by pipeline or the provision of sewer service. What these companies all have in common is the fact that they own fixtures laid out as rails, pipelines, or other pipes or wires, throughout various counties and states, and it would be a hardship to require a local fixture filing in each county where they own fixtures. The rule was therefore established in section 9-401 (5) that one filing per state is enough, and that it must be made in the office of the Secretary of State. Such a filing is a fixture filing as well as a chattel filing, and should be placed in a special filing system set up for the purpose.

#### *Perfection in general*

There are four ways to perfect a security interest, not all of which are, however, usable for all types of property. They are: the taking of possession, filing, noting on a certificate of title, and enjoying a secret security interest. Secret security interests are tolerated for a variety of reasons: to give a seller or his financier time to file (section 9-301 (2)); to allow short-term trust receipt transactions to take place without cluttering the files (section 9-304 (4) and (5)); and to relax requirements in non-commercial situations (section 9-302 (1) (e) and (d)).

#### a) CONSUMER GOODS

The most important case in this last category is, of course, the purchase money security interest in consumer goods, which can, under the old as well as the new Code, be perfected without filing or taking possession, unless the consumer goods are "motor vehicles required to be registered" section 9-302 (1) (c). If there is a certificate of title law on the books, perfection must be by notation on the certificate (section 9-302 (3) (b)); otherwise it must be by filing. An improvement would have been achieved, had the draftsmen used the expression "goods required to be registered" instead of "motor vehicles," because (as they realized when they wrote the Comment to the conflict of laws section (section 9-103), where they do use the broader term "goods") certificate of title laws usually cover trailers, mobile homes, and sometimes even boats, as well as motor vehicles.

Let me now face a hard question: How true is it that security interests in consumer goods need not be filed? The best way to find an answer is to give the various exceptions to section 9-302 (1) (d) which states the broad no filing rule.



First of all, as the quoted section shows, non-purchase money interests in consumer goods are subject to filing.

Second, there is a requirement of filing or notation on a title certificate for all motor vehicles and other goods required to be registered.

Third, consumer goods which are not removable are subject to the requirement of a fixture filing, not for perfection, but for priority over real estate parties.

Fourth, original domestic appliances are subject to a fixture filing for priority over construction mortgagees.

And fifth, under section 9-307 (2) which has remained unchanged in the revision, filing is required for superiority over consumers who have bought the goods for their own personal, family or household purposes.

This multiplicity of exceptions and provisos is a good illustration of the sophisticated approach used by the draftsmen. In the most important cases, filing is required for one purpose or another, and hence the general rule is seriously misleading. The exceptions erode the whole policy of not cluttering the files with consumer transactions, because any financier who takes his security interest seriously is going to file, simply because the rules on when to file are beyond his comprehension. If this is so, the whole system should be changed, and consumer goods should be treated like equipment for filing purposes.

#### b) LOW COST AGRICULTURE EQUIPMENT

In addition to consumer goods, the old Article Nine provides that agricultural equipment with a purchase price of not more than \$2,500 can be the subject matter of a secret purchase money security interest. This rule was intended to help the farmer, by making it less cumbersome for those who sell him small equipment to have perfected security interests. The intent was misguided, because sellers of equipment do not need such an incentive to induce them to make their sales. And the effect of the provision, far from helping the farmer, was actually to damage his credit, because he was in some cases unable to use his already acquired equipment as collateral for a loan since his lender had no assurance that a secret purchase money security interest was not burdening it. For this reason the provision was abolished in the new Code.

#### c) INTANGIBLES

In the area of intangibles, a rule of the new Code makes explicit that a security interest created in a beneficial interest in a trust or decedent's estate is exempt from filing because of its unusual and non-commercial character.

In addition, the assignment of accounts which may be a part of a general assignment for the benefit of creditors is explicitly exempt from

filing in the new Code (section 9-302 (1) (g)); the same is true implicitly under the old Code, since the assignor does not seek financing in that sort of a transfer.

#### d) KNOWLEDGE OF UNPERFECTED SECURITY INTERESTS

Once perfection has been accomplished by any means, it strengthens the rights of the secured party in various degrees, depending on the priority attained. But as a bare minimum, it assures precedence over lien creditors and transferees outside the ordinary course of business and, in the case of accounts and general intangibles, any subsequent transferees (section 9-301 (1)). But what rights does the *unperfected* security interest confer against these parties?

An important change was made in the new Article Nine for the case of lien creditors. The old rule is that even an unperfected security interest confers priority over a lien creditor who had knowledge of the security interest at the time he obtained his lien (section 9-301 (1) (b)). The new rule is that the unperfected security interest loses out in all cases against the lien creditor. The new rule is an aspect of the shift toward more cases of required filing and more direct consequences for failure to file, which shows itself in the new Code.

And yet, for no apparent reason, the element of knowledge has been retained for the case of transferees outside the ordinary course, transferees of accounts, and general intangibles. The equities that assist them are, if anything, stronger than those of the lien creditor, and it seems to me that if a lien creditor with knowledge can, under the new Code, prevail over an unperfected security interest, a transferee outside the ordinary course or a transferee of accounts or general intangibles should also prevail despite his knowledge. Abolishing the knowledge requirement for a lien creditor is, in effect, to pass judgment on the secured creditor who has not gone to the trouble of perfecting his security interest. It assumes that he was not serious enough about having it, for if he really wanted to be secure, he would have perfected. But if that is the case, then he should be subordinated, not only to the knowing lien creditor, but to all later transferees, with or without knowledge of his flimsy security interest.

In fact, I would declare the unperfected security interest void even against the debtor himself, because a creditor who does not trouble himself with the formalities of perfection, in cases where those formalities exist, does not deserve the special privileges of execution which a security interest confers.

#### *Perfection of proceeds*

We have already seen what proceeds are and discovered that under the new Article Nine they need not be claimed in the security agreement or financing statement. The issue now is: How does one perfect a security interest in proceeds?

## a) SECURITY INTERESTS PERFECTED BY FILING

The old Article Nine gives an exceedingly simple and convenient answer: if, as is invariably the case under present-day practice, the creditor has claimed proceeds by checking off the little box on his financing statement, he has a perfected security interest in proceeds. The idea behind this rule is that since he has claimed proceeds on his financing statement and this statement is on file, there is constructive notice of his right to proceeds. The fallacy behind it, however, is that it assumes that the place for filing the original collateral is also the place for filing for proceeds. This is not the case if, for example, the original collateral was inventory (for which filing generally is in the state where the collateral is situated) and the proceeds are accounts (for which filing is at the place where the assignor keeps his records). Furthermore, the proceeds may not be susceptible of filing at all. Such is notably the case with regard to instruments, a security interest in which can only be perfected by the creditor's taking possession. It makes no sense to allow a security interest perfected by filing to exist in this kind of property simply because it constitutes proceeds.

The rules of the new Article Nine meet these objections, and provide (section 9-306 (3)): First, if the proceeds are of a kind for which the original filing is appropriate, no reperfecton is needed. There is no need to claim the proceeds in the financing statement, since such a claim is now clearly implicit. In fact, there is even no need that the description of the original collateral be sufficient to identify the proceeds, except in the case where the proceeds were bought with cash proceeds and are thus indirect. For example, if the financing statement covers automobiles, and the debtor, a dealer in this hypothesis, sells one of them for chattel paper, the secured party has a perfected security interest in the chattel paper despite the fact that the financing statement contains no mention of it. Second, in other cases, the secured creditor enjoys a secret security interest for a period of ten days, during which he must file or take possession of the proceeds if he wishes his security interest to continue perfected thereafter. Third, for cash proceeds an exception was made to these two basic principles. If a financing statement has been filed, the security interest in identifiable cash proceeds continues perfected indefinitely as a secret security interest. However, cash proceeds do not remain in that state very long anyway. If they are not paid over to the secured creditor, they are soon spent as a part of the business.

## b) SECURITY INTERESTS PERFECTED WITHOUT FILING

How long, if at all, does the claim to proceeds remain perfected when the security interest is perfected without filing? Two situations are likely to arise: The first would be one in which the secured party and the debtor have engaged in a trust receipt transaction for which, under section 9-304 (4) or (5), the creditor's interest remains perfected

for twenty-one days. Suppose that after only five days the debtor has sold the merchandise and now has an account. Does the creditor's security interest in this account remain perfected for the remainder of the 21 days, or does he have only ten more days from the date of conversion of the merchandise into proceeds in which to file a financing statement? This point is covered by an addition to the Comment to section 9-304, which states:

Finally, it should be noted that the 21 days applies only to the documents and to the goods obtained by surrender thereof. If the goods are sold, the security interest will continue in proceeds for only 10 days under Section 9-306, unless a further perfection occurs as to the security interest in proceeds.

This comment is supported by section 9-306 (3) (c), which continues the security interest in the original collateral into the proceeds only if the right in the proceeds as such was perfected during the ten day period. Yet its effect, as applied to a trust receipts transaction, is unfortunate. Bankers in possession of trust receipts are given a secret security interest, precisely because of the short duration and frequency of their transactions and of the policy decision not to clutter the files. They understand that their debtors will sell the document or the merchandise represented thereby, and thus that an account or chattel paper will arise. But they do not know precisely when each sale will take place, and hence, under the rule spelled out in the Comment, they will have to file within ten days of their transactions with regard to the accounts or chattel paper. Thus the policy of facilitating trust receipt transactions and not cluttering the files is seriously undercut.

The rule of the Comment does, however, work to the benefit of the secured creditor in some cases, since there is nothing to prevent him from tacking both periods of secretly perfected security interest to one another. In the most extreme case, if the debtor sells the goods at the very end of the twenty-one day period, the creditor gets a total of thirty-one days in which to file as to the proceeds.

And in some cases, the rule set forth in the Comment does not require the bank to file in respect to proceeds at all. Those are the cases in which the account, which arises out of the sale of the merchandise secured by the trust receipt, does not alone or in conjunction with other accounts transfer a significant part of the outstanding accounts of the debtor (section 9-302 (e)). Here, the security interest in the account is perfected before the expiration of the ten day period, as required by section 9-306 (3) (c) for proceeds. And there is no requirement, either in the section just quoted or in the Comment under discussion, that the perfection in proceeds be by filing. It can be by any means appropriate for the kind of things of which the proceeds happen to consist.

For the case of consumer goods, as to which there is also perfection without filing or taking possession, I see no problem, because the proceeds of consumer goods are likely to be either other consumer goods

(in the case of trade-ins), or cash proceeds, or isolated general intangibles (insurance proceeds in particular), as to which filing is not required under the policy of section 9-302, especially subsections (c) and (e).

*Protection of buyers of goods, instruments, and chattel paper*

a) BUYERS OF GOODS

The rule for the protection of buyers of goods given in section 9-307 remains unchanged in the Revision. Two points in it deserve discussion. The first is that, as an exception to the general rule, buyers in ordinary course of farm products do not take free of the security interest created by the farmer. As is apparent from paragraph B-9 of the General Comment, the Review Committee debated whether or not to delete this anomalous exception on which it found feelings running very strong. The Committee realized that the better view would be to delete it, yet it dared not effect a change in the section, for fear of widespread non-conforming amendments as the new Article Nine was passed by state legislatures. It did go so far as to recommend an optional amendment, but the Permanent Editorial Board decided against making this recommendation. The main reason preventing the change is the fact that the federal government, which is an important crop lender, insists on preserving its security interest in crops against buyers and auctioneers, which is given to it by federal common law.<sup>11</sup> It would be absurd indeed to have the federal government prevail against good faith buyers of farm products and let other lenders lose. Yet so long as the U.C.C. remains unchanged on this point, the federal common law rule is not likely to change either. Here it was the peculiar structure of our federal system which prevented a necessary reform from being carried out.

The other point on which a change should have occurred, but upon which the General Comment is silent, is the requirement that the security interest, of which the buyer in ordinary course is free, be one created by the seller and not by some third person. The problem is likely to arise only in the case of second hand goods bought by consumers, and the effect of the present rule unfortunately is to let the financing institution prevail over the consumer who, since he is buying a second-hand product, is not apt to be among the financially favored members of society. Suppose that a bank finances the purchase of an automobile in a state that does not have a certificate of title law; that the buyer then trades it in or sells it to a dealer other than the one from whom he purchased it, who then resells it to another consumer. The second consumer is clearly a buyer in the ordinary course of business, since he is buying from a dealer (section 1-201 (9)), yet he loses against the bank under section 9-307, because the only security interest of which the consumer takes free is one created by his seller, and this particular security interest was created by the first buyer of the automobile. Is one to

<sup>11</sup>See the authorities cited in *U.S. v. McCleskey Mills, Inc.*, 409 F.2d 1216 (5th Cir. 1969).  
<https://scholarworks.umt.edu/mlr/vol34/iss1/3>

search the files now every time one buys a used car from a dealer? If so, under the name of which debtor would one look in his search? Is the bank not well enough protected by its security interest in the proceeds of the sale by the first buyer and its action of conversion against the dealer, which is also a secured right to proceeds?<sup>12</sup>

The existing rule has only one advantage: it is consistent with the rules on the entrusting of goods to a merchant, found in section 2-403 (2). Not everyone who buys in ordinary course from a merchant prevails under this section either, but only those who are fortunate enough to buy goods which the person with the right to possession actually entrusted to the merchant. There is no rule in the United States protecting all buyers in ordinary course, similar to the one on "market overt" found in section 22 of the English Sale of Goods Act,<sup>13</sup> though in my view such a rule would be desirable.

#### b) PURCHASERS OF INSTRUMENTS

When it comes to the protection of purchasers of instruments, the old Article Nine contains an inconsistency. If the instrument stands alone and is not a part of chattel paper, section 9-309 requires that the purchaser be a holder in due course, and if he knew that a secured party was claiming the instrument as proceeds of inventory, he would not qualify as such and the rights of the secured party would be stronger than his. However, if the instrument was a part of chattel paper, he would prevail under section 9-308, which provides: "A purchaser of chattel paper who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in chattel paper which is claimed merely as proceeds of inventory subject to a security interest, even though he knows that the specific paper is subject to the security interest."

The new Article Nine has eliminated this inconsistency by widening the scope of protection of section 9-308 to include not only purchasers of chattel paper, but purchasers of simple instruments as well. Both now prevail over the security interest in proceeds of inventory regardless of knowledge. This rule exists in order to allow the debtor to collect or discount the proceeds before accounting for them to the secured party or using them in his business, if the security agreement so provides.

The second installment of this article which will appear in the next issue of this law review, will deal with the entangled subject of priorities (with an emphasis on fixtures), and with the new rules on future advances, on where to file, and on conflict of laws.

<sup>12</sup>See *New England Merchants National Bank v. Auto Owners Finance Co.*, 355 Mass. 487, 245 N.E.2d 437 (1969).

<sup>13</sup>*Sale of Goods Act*, 56 & 57 Vict., ch. 71 (1892).